April 25th, 2022

Ms. Vanessa Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Re: Private Fund Advisers; Documentation of Registered Investment Adviser Compliance Reviews (Release No. IA-5955; File No. S7-03-22)

Dear Ms. Countryman:

The Small Business Investor Alliance (SBIA) submits these comments in response to the Securities and Exchange Commission's (SEC) February 9th proposed rule that would significantly expand regulatory burdens on providers of private capital without any new statutory mandate or change in market conditions (Proposal). The Proposal is massive in scale, cost, and complexity but lacks study and justification. Further, the SEC has provided wholly inadequate time for the private sector to review the Proposal and its far reaching and long-lasting implications.

The SBIA is the leading national association that develops, supports, and advocates on behalf of policies that benefit private equity investment funds that provide capital to small and mid-size American businesses, as well as the institutional investors that provide capital to those funds. SBIA's public policy goals are focused on maintaining a robust, healthy, and competitive market for private equity investing in American businesses. SBIA is not hostile to all regulations, and we support regulations that promote a healthy and transparent market. We recognize that a healthy market needs an effective level of regulatory oversight to police bad actors and maintain investor protections. However, this Proposal does not promote a healthy market for small business investing. To the contrary, it makes it harder to invest in small businesses and will reduce competition in the private equity industry by creating barriers to entry and making it more difficult for smaller funds to maintain the vital role they play in small business capital formation.

This Proposal represents a major regulatory overreach that will hamper the ability of funds to invest in the small and mid-size domestic businesses and harm the ultimate investors – including retirees and pensioners – that depend on private funds producing robust and sustainable returns over a long period of time.

The Proposal also comes at a time when the SEC has embarked on an unprecedented regulatory blitz spurred by political whims and not new statutory implementation. Just this year, the SEC has released sixteen (16) separate rule proposals, in addition to several that were issued at the end of 2021. These proposals are incredibly complex, and collectively they would impact every corner of the capital markets in the United States.

Despite the massive scale of the new regulatory burdens being proposed, the SEC has not conducted any type of holistic analysis to examine the impact all of these proposals together would have on job creation, capital formation, and the broader U.S. economy. The SEC has also not provided sufficient time for stakeholders to analyze, much less provide feedback, on these proposals, often providing only thirty (30) days for comments to be submitted once a rule is published in the Federal Register. The 30-day comment period is clearly perfunctory and not intended to allow for meaningful public review and substantive comment. For example, the release accompanying the Proposal includes hundreds of questions, some of which consider additional mandates that are not explained or examined fully in the release. The 30-day comment period provided for by the Proposal is simply inadequate for the public and regulated entities to properly consider and submit informed comments that address the Proposal's material consequences.

As explained throughout this letter, SBIA is concerned that the Proposal embraces and attempts to put into regulation falsehoods about private equity and will create significant costs for small private funds and their investors. The Proposal would also unnecessarily apply new regulations to small business investment companies (SBICs)[1] and rural business investment companies (RBICs) which are already subject to rigorous licensing and disclosure requirements from the Small Business Administration (SBA).

We urge the SEC to cease reinventing the regulatory framework of the private capital markets without a Congressionally authorized mandate to do so. It is not within the role or authority of the SEC to intervene in private contract negotiations between sophisticated parties or to dictate specific commercial outcomes. SBIA accordingly provides following recommendations and observations regarding the Proposal:

1. **Prior to issuing any final rule, the SEC should provide the public with additional time to comment on this and other proposals and should assess their cumulative impact upon capital formation, job creation, and the broader economy with a particular emphasis on the impact to investing in small and medium-sized businesses;**

2. **The Proposal is based upon falsehoods of how private equity works and will curtail the flow of capital to small and mid-size businesses while providing little in the way of enhanced investor protections;**

[1] SBICs are primarily formed as limited partnerships and they provide equity, long-term loans, or debt-equity investments along with management assistance to small businesses across a range of sectors, geographic locations, and stages of growth. SBICs are privately owned and managed and are licensed and regulated by the Small Business Administration (SBA). At the start of 2020, there were nearly 300 licensed SBIC funds representing nearly $30 billion in domestic capital. All of this capital is or will be invested in American small businesses.

3. **The Proposal fails to recognize current practices of private funds and would impose prescriptive, one-size-fits-all (with one-size-harms all, but harms smaller funds disproportionally) mandates that would be of questionable value for investors;**

4. **The Proposal would risk impairing private contracts, which are governed under state law and are carefully negotiated and agreed to by general partners and limited partners of private funds;**

5. **Some of the prohibited practices outlined in the Proposal are reasonable and well-intentioned and have merit; however, they are interspersed with bad ideas that are a significant departure from current standards and would result in harmful consequences; and**

6. **The proposed restrictions on "preferential treatment" are based upon a misunderstanding of side letters and would be unworkable in practice.**

SBIA Survey

In order to gain at least an initial understanding of the real-world impact of the Proposal, SBIA conducted a survey of our membership to assess their views on various provisions. For context, the survey helps provide the perspective of smaller private fund managers that serve the middle market and lower middle market:

Survey Results

- **95%** of respondents stated the proposal would raise their compliance costs and burdens. Respondents also stated that the Proposal would disproportionately impact smaller funds and create barriers to entry in the industry.

- **96%** of respondents believe that eliminating the "2 and 20" compensation would "severely" disincentivize private fund formation and investment.

- **86%** of respondents state they "seldom" receive requests from investors for additional information regarding fees and expenses other than what funds already provide pursuant to a limited partnership agreement.

- **68%** of respondents state they "seldom" receive requests from investors for additional information regarding historical performance other than what funds already provide pursuant to a limited partnership agreement.

- **81%** of respondents state that investors "seldom or never" request third party fairness opinions in conjunction with adviser-led secondary transactions.

SBIA Comments on the Proposal

The results of SBIA's survey help inform several of our observations and recommendations which are explained in further detail below.

1. Prior to issuing any final rule, the SEC should provide the public with additional time to comment on this and other proposals and should assess their cumulative impact upon capital formation, job creation, and the broader economy with a particular emphasis on the impact to investing in small and medium-sized businesses.

SBIA remains concerned that the SEC has not provided the public with a reasonable amount of time to comment on the many complex rule proposals issued over the last several months. As SBIA and other organizations noted in a letter to Chairman Gensler, recent SEC proposals collectively run to 3,570 pages and ask commenters to respond to 2,260 individual questions.[2] The SEC's regulatory agenda includes proposals involving:

- Shortening the settlement cycle;
- Climate-related disclosures for public companies;
- Special Purpose Acquisition Companies (SPACs);
- Money market fund reforms;
- Short sale reporting;
- Securities lending;
- Request for information regarding digital engagement practices;
- New disclosure and regulatory requirements for private funds;
- Amendments to Commission Rule 3b-16 and Regulation ATS for ATSs that trade government securities, NMS stocks, and other securities;
- New cybersecurity risk management rules;
- First time reporting obligations for security-based swaps;
- New anti-fraud/anti-manipulation requirements for SBS;
- First time reporting obligations for large SBS positions;
- Further defining the terms dealer and government securities dealer along with related registration requirements; and
- Significant amendments to beneficial ownership reporting rules.

Regrettably, the SEC has provided in many cases only thirty (30) days for the public to respond to proposals once they are published in the Federal Register. That is simply an inadequate length of time for the public (particularly those who will be directly impacted) to submit informed feedback to the SEC. It also does not assist the SEC in gaining an understanding how these rules will *collectively* impact the markets and the broader economy. Accordingly, we believe the SEC should provide additional time for the public to submit comments on each outstanding rule proposal.

2. The Proposal is based upon falsehoods of how private equity works and will curtail the flow of capital to small and mid-size businesses while providing little in the way of enhanced investor protections.

[2] https://www.sifma.org/wp-content/uploads/2022/02/SEC_Joint-Trades_Comment-Period-Letter_4-5-2022.pdf

Private equity is a positive force for creating jobs, seeding innovations, and expanding prosperity to the people and places that are not yet fully benefitting from our system of free enterprise. The profits from private equity fund the retirement security of millions of pensioners and provide the scholarship money used to provide educational access to a new generation of college students. These private equity investments are commonly made in areas of the country that are otherwise passed over or passed by. Most of our member funds are located in Little Rock, Indianapolis, Buffalo, Omaha, Kansas City, and many other places that are far from Wall Street or Silicon Valley. Regardless of investing style, private equity investors in small and medium-sized businesses make money by helping the businesses grow and succeed.

Private equity helps business grow by not only providing critical, patient capital that conventional banks cannot, but also by helping the smaller business learn how to grow and make big leaps forward that they otherwise would not have been able to achieve on their own. The only way to be a successful private equity fund in the lower and middle market is to find smaller businesses and help them grow into bigger, better businesses.

Private equity is a continuum that spans from the very early-stage small angel investors to the largest buyout funds and everything in between. A robust economy requires every segment of this continuum to be healthy. Without angel investors there would be less venture investing, with less venture investing there would be less venture lending; with less venture lending there would be less growth equity investing, and with less growth equity there would be fewer small buyouts and small spin off investing; and so on. While we segment these investing styles for the sake of simplifying and explaining them, the reality is that they are interconnected parts of the private equity continuum that commonly overlap. Each segment is inextricably interconnected. In a healthy economy every segment of this private equity market must exist and be allowed to work. Policymakers cannot harm any segment of the continuum without damaging the health of the whole investing market and reducing the positive benefits of private equity on the American economy.

Unfortunately, private equity has been the target of unfair criticism in recent years which has led to calls for heightened and costly regulation. While SBIA believes that appropriate SEC oversight of private funds is critical for investor protection, the Proposal misses the mark and will impose enormous costs on funds and their investors. These costs will fall unevenly on small private equity firms and create barriers to entry for the industry. This will especially harm the middle and lower middle market which often rely on small private equity firms to meet their capital needs.

The 2/20 compensation model for private funds has particularly come under attack for being outdated and harmful to investors. Some commentators equate the evolution of fees in mutual funds or ETFs – which are standardized products that can be bought and sold every day – with actively-managed private funds, which is not an apples-to-apples comparison. That argument is fundamentally misleading and showcases the type of misinformation that exists about how the private market functions, particularly the smaller end of the market. The amount of time private funds spend finding promising small businesses, analyzing and conducting risk assessments, helping these small businesses modernize and grow, developing management teams to take their smaller businesses to the next level, raising money from institutional and accredited investors,

and then working closely together with portfolio companies as a management advisor and strategic partner, can in no way be compared to standardized, digitized products that can be bought and sold on a smartphone. There is a reason why the fee models in the private market are structured in a way to provide managers the resources needed to produce consistent returns and to align the interests of funds with their investors. SBIA members do not earn gains until their portfolio companies create a return on investment (i.e. grow the small business). The fee models, including the 2/20 option, is a voluntary fee model that is mutually agreed upon by willing and informed parties and the SEC has no place to dictate market terms between informed parties. Private equity funds only earn the 20% "carry" once investors receive their return, and agreements typically contain general partner clawback provisions if a fund does not deliver projected returns.

To be clear, SBIA strongly supports efforts by the SEC to identify and take action against bad actors and to address any harmful practices that occur within private equity or any other industry. But the Proposal paints the entire private equity industry with one brush and will impose sweeping, ongoing regulatory mandates that will not protect investors or enhance the flow of capital to businesses that need it.

3. <u>The Proposal fails to recognize current practices of private funds and would impose prescriptive, one-size-fits-all (with one-size-harms all, but harms smaller funds disproportionally) mandates that would be of questionable value for investors.</u>

The Proposal outlines several standardized disclosures that private funds would have to follow when providing certain information to investors. The release explains these requirements are intended to address the "opacity that is prevalent in the private fund structure."

SBIA agrees that investors should not be left in the dark regarding basic information about a fund's fees, expenses, and performance. However, the Proposal fails to recognize the extent to which private funds already provide such information to investors, albeit often in a different format or frequency than what is prescribed by the Proposal. Further, SBIA's survey shows there is a disconnect between assertions made in the Proposal regarding investor demand for certain information and the extent to which investors are actually calling on funds to disclose more information than they are already providing. Smaller funds are extremely responsive to the needs of their limited partners and these needs are agreed to in the Limited Partnership Agreement (LPA).

Adding additional and unrequested reporting requirements on smaller funds with much smaller administrative resources is not helpful and shows the extent of misunderstanding advocates of these provisions have for smaller funds – whom they generally do not invest in. While organizations such as the Institutional Limited Partners Association (ILPA) which are comprised of very large funds support these requirements of the Proposal, it is clear that LPs who invest in small businesses were not considered when the SEC developed these proposed regulations. Prior to issuing any final rule, we believe the SEC must consider whether commenters who support the Proposal actually invest in funds that in turn invest in small and middle market businesses. It would be telling if support for the Proposal stems primarily from large, multinational institutions that invest in larger funds which do not have any experience investing in small business.

For example, the vast majority of respondents to SBIA's survey (86%) stated that investors *seldom* request more information regarding fees and expenses than what is already provided under the terms of the LPA. Over two-thirds (68%) say that investors *seldom* request additional information regarding performance data beyond what is agreed to by the LPA. Many respondents explained fee and performance information is disclosed in a manner set forth by the LPA.

Perhaps unsurprisingly, SBIA's survey also found that a transition to many of the prescriptive mandates in the Proposal would create significant compliance costs. 95% of respondents stated that the quarterly reporting requirements contained in the Proposal would raise their compliance costs, including 42% who said costs would be "significantly" raised.

Furthermore, the Proposal would require that quarterly statements be provided within 45 days of a quarter's end. This is not a sufficient amount of time for funds to provide a fourth quarter report, particularly for advisers to SBICs that may find themselves subject to the provisions of the Proposal. SBICs are already regulated by the SBA, which requires specific reporting obligations. The fourth quarter report of SBICs must be audited and an SBIC has until March 31st to submit the report. Without a similar timeline, there could be discrepancies between information provided to LPs under the proposed rule and what is sent to the SBA.

Another concern is that the Proposal's definition of the term "substantially similar pool of assets" is defined in the context of the fund strategy and not holdings. It is not uncommon for a private fund manager to raise a series of sequential funds over a number of years which follow the same strategy. While there may be multiple funds open and in operation there is typically not more than one or two that are actively investing. Several of the proposed reporting requirements would cause the manager to report information on substantially similar pools of assets or, in other words, information from all funds to the LPs of each fund. This could be confusing and is unnecessary. Unlike managers of liquid funds which might have multiple "buckets" or funds into which they could allocate new investments, closed-end managers of private funds do not have that conflict and therefore this definition is irrelevant. If the idea behind the Proposal is to prevent the selective allocation of investments across multiple funds, it misses the mark.

If the goal of the SEC is to make sure that private fund investors are properly informed about fees, expenses, and performance, it should look to how funds are currently providing this information in a way that is tailored to the demands of their investors. Again, as the SEC looks at comments it should consider whether respondents actually invest in the smaller funds that invest in small businesses. At best, small business investing is an afterthought in this proposal.

4. <u>The Proposal would risk impairing private contracts, which are governed under state law and are carefully negotiated and agreed to by general partners and limited partners of private funds.</u>

One of the more concerning aspects of the Proposal imposition of new requirements on existing private contracts negotiated and entered into in good faith by private parties. This represents a major departure from how the SEC has historically carried out its regulatory role of private capital markets and sets a troubling precedent for the future.

General partners and limited partners spend a significant amount of time and resources negotiating and agreeing upon LPAs that structure investments in certain funds. These negotiations involve sophisticated parties with deep knowledge of the capital markets and the risks and opportunities involved with private investment vehicles.

As Commissioner Peirce noted in her dissent, the Proposal:

> "..embraces a belief that many sophisticated institutions and high net worth individuals are not competent enough to obtain and analyze the information they need to make good investment decisions or to structure appropriately their relationship with private funds."[3]

SBIA echoes these sentiments and urges the SEC to avoid micromanaging the way in which experienced, sophisticated parties negotiate the terms of investment contracts. As the results of SBIA's survey show, it appears that investors do not see this as a challenge that requires regulatory action. Given current macroeconomic conditions and market uncertainty generally, this is not the time for federal regulators to advance a solution in search of a problem.

5. Some of the prohibited practices outlined in the Proposal are reasonable and well-intentioned and have merit; however, they are interspersed with bad ideas that are a significant departure from current standards and would result in harmful consequences.

The Proposal contains a list of proposed "prohibited activities" for advisers to private funds. The SEC explains that these prohibitions are intended to prevent situations where an adviser puts their own interests ahead of investors. SBIA agrees that mitigating conflicts of interest in the private fund space is a worthy goal of regulation. Investor confidence is undermined when bad actors abuse their position and profit at the expense of long-term investors. Certain of the proposed prohibitions are reasonable and could enhance investor protection. For example, prohibiting an adviser from charging portfolio companies for services the adviser does not perform (or reasonably expect to perform) can benefit investors.

However, other proposed prohibitions are problematic. For example, prohibiting the allocation of fees and expenses to a fund that are associated with the costs of examination or investigation by a regulator would conflict with how many LPAs are structured. LPAs already typically cover the allocation of such fees and expenses; market standards already exist to govern the allocation of those costs to a fund. Additionally, LPAs often require the disclosure of such events and it is unclear how an outright prohibition would further the interests of investors.

The Proposal also prohibits an (a)(7) investment adviser from borrowing money from a private fund client. Many SBIC investors are banks which would therefore be prohibited from lending to the investment advisor or affiliates. It does not appear this rule would prohibit a fund or a portfolio investment from borrowing from an investor. However, if the SEC intends those transactions to be prohibited then this rule would act as an impediment to capital formation as a bank would have to weigh the decision to invest in the fund knowing that it would lose the opportunity to lend to portfolio investments or the fund itself.

[3] Statement on Proposed Private Fund Advisers; Documentation of Investment Adviser Compliance Reviews Rulemaking

SBIA is also concerned about the proposed prohibition against excluding taxes already paid from GP compensation clawbacks. GP clawbacks are a standard feature in the private equity world. Since GP compensation is largely derived from the 20% "carry" of profits earned by the fund, there can sometimes be a disconnect between the compensation paid to a GP and the actual performance of the fund over time. For example, if a fund performed very well in its first few years of operating but very poorly in the latter years, a GP may end up earning more than what had been agreed upon in terms of the GP's incentive compensation structure. This leads to a situation where excess compensation paid to a GP may be clawed back but the GP has already paid taxes on the carried interest that has been earned.

Deducting the amount of taxes already paid from a clawback prevents a GP from effectively "double paying" their taxes owed – once when taxes are actually paid to the government, and again through the clawback of compensation.

If the proposed prohibition were to go into effect, however, a fund would likely have to amend its previous tax returns or negotiate retroactive changes to its compensation agreements. Doing so would affect not just a fund but all of its investors as well. We urge the SEC to drop this idea as it would create unnecessary burdens for funds and their investors while providing nothing in the way of investor protection.

Additionally, the Proposal would prohibit advisers – including SBICs - from seeking reimbursement or indemnification in certain instances involving breach of fiduciary duty or negligence. These prohibitions may be well-intended, but we note they may conflict directly with state law – a reality that the SEC acknowledges in the Proposal. Private contracts are generally governed under state law and it is inappropriate for the SEC or any Federal agency to impair contractual agreements that parties have agreed under the laws of a particular state. From a policy perspective, the standard used by the SEC in the Proposal is also at odds with the *gross negligence* standard that has become common market practice. The resulting increase in liability costs will be substantial, especially for smaller funds that have operated under the *gross negligence* standard for years.

6. <u>The proposed restrictions on "preferential treatment" are based upon a misunderstanding of side letters and would be unworkable in practice.</u>

The Proposal would require disclosure of side letters to all investors. It is unclear what types of terms would have what the Proposal describes as a "material, negative effect on other investors" while still being consistent with the LPA and the manager's fiduciary duties. Further, most private equity funds hold multiple closing events meaning that it would be impossible for those in the first round to see a side letter from an LP in the final close. It would seem that this would either necessitate a single close (which the market has generally deemed unwieldy or else that would already be the practice) or allow early investors the opportunity to opt-put if a later side letter is of concern. This approach would ultimately make all LP commitments prior to the final close non-binding and endanger the fund's ability to make investments.

The same section prohibits what the SEC calls "preferential transparency." In the case of public companies, the SEC established Regulation Fair Disclosure (Reg FD) to prohibit the selective disclosure of information to investors that could then buy or sell stock almost instantly. This is very different than information about portfolio companies within a private equity fund's portfolio. Even if one LP were to receive information that raised concerns about the portfolio, what action could it take that would "harm investors?" Perhaps it could seek a secondary buyer of its LP interest, but that is a process that takes a not-insignificant amount of time and would be accompanied by a due diligence effort on behalf of the buyer of the LP interest. In other words, an LP with "preferential" information is not able to front-run any other investors to either buy or sell interests in the fund like might be possible in the public stock market.

Beyond a lack of need, the implementation of this rule would be problematic. Some LPs maintain their own proprietary spreadsheets to track portfolio company information. While generally asking for similar information, there can be differences in content and format. GPs can assist LPs in updating their spreadsheets each quarter to assist in their internal, investment management process. The Proposal would require GPs to share these populated spreadsheets with all investors despite the fact that they are the intellectual property of the LPs. Without knowing what "harm" the SEC is attempting to prevent, it is difficult to anticipate what information might be safe to share selectively and in practice would require the manager to share everything with all LPs. Ultimately, it would result in LPs being bombarded with information that they did not request, that will likely be redundant, if not irrelevant, and require the fund to share proprietary reporting templates created by LPs.

Lastly, it has come to our attention that the proposed rule could potentially capture subsidiary vehicles like special purpose vehicles (SPVs), even ones controlled by regulated investment companies (RICs). We simply don't believe that is necessary because RICs are already regulated under the Investment Company Act, and any activities in a SPV controlled by a RIC would already be disclosed.

Conclusion

As explained in this letter, SBIA urges the SEC to rethink the Proposal – and any need for additional regulation of private funds – in its entirety prior to deciding whether to move forward with any new rules for private funds. The SEC must take efforts to properly assess the impact of this and other rule proposals, especially during a continued difficult economic period in the U.S. economy. SBIA looks forward to being a resource to commissioners and staff on these important issues.

Sincerely,

Brett Palmer
President
Small Business Investor Alliance